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Case Note: Underwood v HMRC: Mysterium Sub Silua Part 2

Beneficial ownership; Capital gains tax; Completion; Contracts for sale of land; Disposals; Sale of land

In the second of two articles on the High Court decision in Underwood v Revenue and Customs Commissioners*, Simon M^cKie examines the implications of the decision for ''bed and breakfast''.*

In a previous article,[1] the author examined the implications of the decisions of the Special Commissioners and the High Court in *Underwood v Revenue and Customs Commissioners*[2] for understanding the nature of a disposal for capital gains tax purposes. Both the Special Commissioners and Briggs J. having proceeded on the basis that a disposal for capital gains tax purposes involves a transfer of beneficial ownership and that the formation of a contract cannot itself constitute a disposal, the question at issue became whether the transactions which took place on November 30, 1994 resulted in the beneficial ownership in the Property passing to Rackham Ltd. Their decisions on this issue have important implications for ''bed and breakfast'' and sub-sale transactions.

Although the facts of the case were set out in the first article, for readers' convenience a summary is given in the box at the end of this article (to which reference should also be made for definitions of terms used in this article).

A logical contradiction?

Briggs J. differed from the Special Commissioners in his grounds for deciding that the transactions which took place on November 30, 1994 did not result in the

[1] Simon McKie ''*Case Note: Underwood v HMRC:* Mysterium Sub Silua—Part 1'' [2008] P.C.B. 281.

[2] *Underwood v Revenue and Customs Commissioners* [2008] EWHC 108 (Ch); [2008] S.T.C. 1138.

beneficial ownership in the Property passing to Rackham Ltd. He saw a logical contradiction in the Special Commissioners' finding that payment of the purchase consideration under the two contracts had been made by way of set-off. He said:

> ''On the hypothesis that Mr Underwood really paid £420,000 under the 1994 contract, [Counsel for HMRC] was unable to explain what asset other than a beneficial interest in the property can have been turned to account by Rackham.''[3]

What Briggs J. seems to have meant is that if Mr Underwood paid money to Rackham Ltd it must have been paid for something and that something could only have been the Property. Yet it was equally clear to him that the beneficial interest in the Property had not passed to Rackham Ltd:

> ''For as long as the present case was argued on the basis of an assumption that the primary facts disclosed a mutual set-off of payments of £400,000 by way of performance of the two contracts, I became increasingly oppressed by the apparently irreconcilable tension between on the one hand, . . . [Counsel for the taxpayer's] . . . submission that Mr Underwood could only have paid £420,000 for a beneficial interest in the property that must therefore have passed, however momentarily, to Rackham, and on the other hand the sensible conclusion of the Special Commissioners that it was both in theory and in practice difficult to see how any such beneficial interest did actually pass, in the sense necessary to constitute a disposal of it for capital gains tax purposes. Disposal is, after all, a concept to be addressed by the application of common sense.''[4]

To release himself from this painful contradiction Briggs J. assumed the function of the tribunal of fact by stating that:

> ''. . . Mr Underwood's objective was not to transfer and re-acquire the property, but simply to remove the 1993 contract as an obstacle to his intended sale of the property to Brickfields for a substantially greater price, an objective which he had the power to achieve by the exercise of the option, at a net cost to him of £20,000. Both Mr Cunningham and Mr Paul Rackham of Rackham Limited gave evidence to the Special Commissioners in the form of witness statements which were not the subject of cross-examination. Neither of them referred to any payment and cross-payment of £400,000 or to any set-off. Both spoke in terms of recognising the obvious commercial reality that, once the option had

[3] *Underwood v Revenue and Customs Commissioners* [2008] EWHC 108 (Ch); [2008] S.T.C. 1138 at 1155.

[4] *Underwood v Revenue and Customs Commissioners* [2008] EWHC 108 (Ch); [2008] S.T.C. 1138 at 1156.

> been exercised by the creation of the . . . [Re-Sale] . . . contract, the net effect of the existence of those two contracts was to yield a profit of £20,000 to Rackham, and that all that needed to be done before Mr Underwood could complete his sale to Brickfields for £600,000 was for him to pay Rackham £20,000 (or in the event promise to pay by way of a debt). That is all that was done. Neither the 1993 nor the . . . [Re-Sale] . . . contract was performed at all. They were simply settled by way of the payment of the difference between the value of their combined rights and obligations to each of the parties. The Special Commissioners *implicitly* [emphasis added] recognised that this was the real outcome in their finding (see [2007] STC (SCD) 659, para 28):
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> > '28 . . . The position as between the Appellant and Rackham Ltd could be *settled* by the payment of the sum of £20,000 by the appellant to Rackham Ltd, being the *difference* between the sale price for the property of £400,000 mentioned in the contract of 2 April 1993 and the amount due to Rackham Ltd from the appellant for the property under the option agreement (£420,000 . . .' (emphasis added)''.[5]

From this Briggs J. concludes that the payment by set-off is an artificial and fallacious construct and that neither contract was performed:

> ''Once, however, the set-off analysis is revealed to be an artificial and fallacious construct, and that in reality all that happened was that the two contracts were settled by payment of a £20,000 difference, without any substantial performance of either of them, then the tension disappears. There was no performance of either contract, there was therefore no transfer of the beneficial interest in the property under either contract, at all. There was therefore no disposal of the property under the 1993 contract, so that there was nothing upon which s.28(1) could bite so as to deem there to have been a disposal in the 1993 year of account.''[6]

If the payments were not made and the contracts were not performed, then when Briggs J. says that the contracts were:

> ''. . . simply settled by way of the payment of the difference between the value of their combined rights and obligations to each of the parties'',

he can only mean that the contracts were cancelled by mutual agreement.

[5] *Underwood v Revenue and Customs Commissioners* [2008] EWHC 108 (Ch); [2008] S.T.C. 1138 at 1155, 1156.

[6] *Underwood v Revenue and Customs Commissioners* [2008] EWHC 108 (Ch); [2008] S.T.C. 1138 at 1156, 1157.

The case reports, of course, do not contain the witness statements, but it is clear from the Special Commissioners' findings of fact that Mr Underwood and his solicitor addressed themselves to the question of how the obligations arising under the 1993 Contract and the Re-Sale Contract could be satisfied.[7] There is nothing in the Special Commissioners' decision to suggest that an agreement was made for the mutual cancellation of the two contracts.

In the event that the case is appealed further, the High Court's decision surely cannot stand, because it is based on a substitution of the facts found by Briggs J. for the facts found by the Special Commissioners and not on an application of the law to the facts found by the fact-finding tribunal.

That may not help Mr Underwood, however, because, contrary to Briggs J.'s view, there is no logical contradiction between the fact that Rackham Ltd did not obtain a beneficial interest in the Property and that payments were made under the contracts by way of set-off. The concept of payment is a protean one[8] dependent upon the context in which the putative payment is made. Undoubtedly, Rackham Ltd satisfied its obligations under the Re-Sale Contract to make a payment to Mr Underwood by set-off against Mr Underwood's obligation to make a payment to it arising under the 1993 Contract. Similarly, Mr Underwood satisfied his obligation to convey the Property to Rackham Ltd under the 1993 Contract by set-off against Rackham Ltd's obligation to transfer the Property to Mr Underwood under the Re-Sale Contract. It seems clear to the author that both contracts were, therefore, performed. Unfortunately for Mr Underwood, the mode of performance did not involve Rackham Ltd acquiring a beneficial interest in the Property for even a *scintilla temporis* except a limited and temporary interest under the doctrine of the estate contract and, on the admittedly rather opaque authority of *Jerome v Kelly (Inspector of Taxes),*[9] that did not constitute a disposal.

Bed and breakfast transactions and sub-sales

If Briggs J.'s judgment stands because either it is not appealed or it is upheld on appeal, the case appears to have significant implications for many bed and breakfast transactions, as well as for the light it throws on the nature of a disposal for capital gains tax purposes. If a higher court were to restore the reasoning of the Special Commissioners, the decision will be of significance in relation to any contract the interaction of which with another contract has the result that the purchaser under the first contract does not obtain beneficial ownership of the asset which is its subject.

[7] *Underwood v Revenue and Customs Commissioners* [2007] S.T.C. (S.C.D.) 659 at 664.

[8] *Barclays Mercantile Business Finance Ltd v Mawson (Inspector of Taxes)* [2004] UKHL 51; [2005] 1 A.C. 684; and *DTE Financial Services v Wilson* [2001] EWCA Civ 455; [2001] S.T.C. 777.

[9] [2004] UKHL 25; [2004] 1 W.L.R. 1409.

Bed and breakfast transactions

Both before the Special Commissioners and the High Court, Mr Underwood's counsel put forward the example of bed and breakfast transactions on the basis that they clearly were accepted to lead to chargeable disposals and yet would not do so applying the principles contended for by HMRC.

Before the enactment of the 30-day identification rule in the Taxation of Chargeable Gains Act 1992 s.106A(5), bed and breakfast transactions most commonly involved a person who wished to realise a hither-to unrealised loss or gain on a shareholding contracting with an institution to sell that shareholding to it. On the following day the individual would contract with the institution to buy back the same number of the same shares. The individual would be exposed to the risk of movements in the value of the share between the time of the two contracts. Under the contracts, in accordance with the normal arrangements for dealing in shares, settlement of both bargains would take place some time after both contracts were concluded. When the time for settlement came, the individual's obligation to deliver shares under his sale contract would be cancelled by his right to receive shares under the purchase contract. Similarly, the amount owing to him under the sale contract would be netted off against the amount payable by him under the purchase contract so there would only be a payment in one direction of the difference between the two prices.

In response to Mr Underwood's counsel Briggs J., said, in relation to bed and breakfast transactions:

> ''There is no reported case in which the question whether a claimed bed and breakfast transaction included the necessary disposal and re-acquisition for capital gains tax purposes has been decided. In *MacNiven*, bed and breakfast transactions were simply identified as an example of transactions which, because of their tax-driven purpose, their circular nature and their artificiality might prima facie attract the *Ramsay* principle, but which were never challenged on that basis because they recognised, and crystallised a real loss (see *W T Ramsay Ltd v IRC; Eilbeck (Inspector of Taxes) v Rawling* [1981] ACT 300). For the purpose of analysis, it was assumed sub silentio that the typical bed and breakfast transaction did involve the necessary disposal and re-acquisition.
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> Where the sale and re-purchase of an asset under a bed and breakfast transaction has been 'properly paid for', and where for however short a period the beneficial interest in the asset has therefore resided with the buyer before resale, as contemplated by the extract from the HMRC Manuals which I have quoted above, there can be no doubt that such a disposal and re-acquisition occurred.

> [Counsel for Mr Underwood] pointed to the fact that, far from there being an overnight sale and repurchase, in the present case the two contracts were some 20 months apart. In my judgment that comparison focuses on the wrong event. The requirement in a bed and breakfast transaction for the contracts of sale and repurchase to be separated in time may be a necessary condition but is not a sufficient condition of its effectiveness for tax purposes. The necessary condition is that the two transactions must have involved a disposal and re-acquisition of the asset, by the passing and repassing of the beneficial interest.''[10]

Briggs J.'s comments here are carefully framed to avoid stating the implications of his judgment for bed and breakfast transactions. It is difficult to see, however, why, if the arrangements for the settlement of the 1993 Contract and the Re-Sale Contract in *Underwood* did not amount to performance of those contracts, the settlement of bed and breakfast transactions by set-off of both the obligations to pay and the obligations to deliver securities should not also be insufficient to amount to performance. One might be able to distinguish the two on the basis that in *Underwood* Briggs J. found that the intention of the parties was to cancel the contracts, whereas in a bed and breakfast transaction their intention would be to complete them, but the distinction is surely wafer thin. If the Special Commissioners' reasoning is restored, it is clear that it must also apply to bed and breakfast transactions because in such transactions there is no point in time at which the institution can call for delivery of the shares from the taxpayer.

Sub-sales

The following is an example of a typical sub-sale transaction.

On October 1, 2008 A contracts to sell a property to B for £1 million with completion to be on October 31, 2008. On October 15, 2008 B contracts to sell the property to C for £1.1 million, also with completion on October 31, 2008. On October 31, 2008 both transactions are completed by A transferring the property directly to C and C paying £1 million to A and £100,000 to B. On the reasoning of Briggs J. it appears likely that on these facts there would be a disposal from A to B and from B to C. It is difficult to see how a transaction in which C pays £100,000 to B and a further £1 million to A could be characterised as the cancellation without performance of the agreements between A and B and between B and C. If the reasoning of the Special Commissioners is restored, however, there would surely be no disposal by A to B but rather from A directly to C. There would be no *scintilla temporis* in which the beneficial ownership of the property would vest in B because at the time that he had a right to call for the property from A he would also be subject to C's right to call for the property from him.

[10] *Underwood v Revenue and Customs Commissioners* [2007] S.T.C. (S.C.D.) 659 at 1153, 1154.

An appeal?

So the decision in *Underwood* potentially has profound effects upon two categories of very common transactions. It is to be hoped that it will be appealed so as to provide clarity both on the narrower issue of the taxation of contracts where, due to the interaction with another contract, the purchaser does not receive an unfettered right to the subject matter of the contract and on the wider issue of the nature of a disposal for capital gains tax purposes.

The dramatis personae

The *dramatis personae* in the case were Mr Underwood and two companies which he controlled, being Brickfields Estate Ltd (Brickfields) and Mac Estates Ltd (Mac Estates) and Mr Rackham and two companies which he controlled, being Anti-Waste Ltd (Anti-Waste) and Rackham Ltd.

The facts

Mr Underwood's purchase of the property

On May 24, 1990 Anti-Waste sold a commercial property (the Property) to Mr Underwood for £1.4 million. His acquisition was partially financed with a £1 million mortgage from a bank (the Bank) secured on the Property.

The 1993 contract

On April 2, 1993 Mr Underwood entered into a contract (the 1993 Contract) with Rackham Ltd for the sale of the Property for £400,000 with a completion date of December 31, 1993.

The option

Also on April 2, 1993 Rackham Ltd granted an option (the Option) to Mr Underwood under which he had the right to re-purchase the Property at any time before December 31, 1995. The exercise price was to be £400,000 plus the cost of any capital improvements made by Rackham Ltd and 10 per cent of the difference between the value of the Property at the date of the Option agreement and its value at the date of exercise. Completion was to be 28 days after the date of exercise.

On April 28, 1993 the Property was valued at £400,000 on the open market and at £290,000 in the event of a forced sale.

The return for 1992/1993

In his tax return for the fiscal year 1992/1993 Mr Underwood claimed a loss on this transaction of £1,174,677.

Delayed completion of the 1993 contract

The Bank would not permit the sale to Rackham Ltd to proceed until the loan was repaid and so Rackham Ltd and Mr Underwood agreed to extend the completion date of the 1993 Contract to December 31, 1994.

Negotiating a re-financing

It appears that Mr Underwood then negotiated a re-financing of his obligations. A Building Society (the First Building Society) agreed to loan £1.25 million to Mac Estates secured by a charge on a property owned by that company. Another Building Society (the Second Building Society) agreed to grant a loan of £355,000 to Brickfields secured on the Property. It was a requirement of both loans that the Property should be sold to Brickfields and the loans were only to be released when that happened.

The re-sale contract

Mr Underwood determined to exercise the Option so as to be in a position to sell the Property to Brickfield.

Peculiarly, Mr Underwood did not give notice under the Option, but rather a new agreement (the Re-Sale Contract) was made between Mr Underwood and Rackham Ltd dated November 29, 1994 under which Rackham Ltd agreed to sell the Property to Mr Underwood for £420,000. This amount was calculated as being 10 per cent of the increase in the value of the Property between the date of the Option (£400,000) and the date of the Re-Sale Contract (£600,000) plus £400,000.

The Brickfields contract

Also on November 29, 1994, the appellant entered into another contract (the Brickfields Contract) under which he agreed to sell the Property to Brickfields for the sum of £600,000. At this stage the date of completion of the 1993 Contract was December 31, 1994 and of the Re-Sale Contract and the Brickfields Contract was December 19, 1994.

The completion(s)?

On November 30, 1994 Mr Underwood executed a transfer of the Property directly to Brickfields in consideration of the sum of £600,000. On the same day Brickfields mortgaged the Property to the Second Building Society and received £353,000 from them. At ''about the same time'' Mac Estates mortgaged its property to the First Building Society and received a mortgage loan from it ''of which £250,000 was available to redeem the loan on the Property''.

£640,000 was paid to the Bank with Mr Underwood finding the balance of £37,000 (£640,000 - £353,000 - £250,000) from his own resources. The Bank then released its charge on the Property. Mr Underwood did not pay the £20,000 to Rackham Ltd until December 4, 1996, Rackham Ltd's books showing a debtor for that amount in the meantime.

The 1993/1994 and 1994/1995 returns

Mr Underwood made no chargeable gains in 1993/1994 and therefore carried forward the unrelieved 1993 losses to 1994/1995 when he set off the greater part of them against chargeable gains.

The assessments

HMRC's position was that there was no disposal under the 1993 Contract but only under the Brickfields Contract. The result of that, presumably, was that Mr Underwood did not make a capital loss in 1992/1993 and in 1994/1995 Mr Underwood would have made a loss of £800,000 (£1.4 million - £600,000) plus an amount equal to the applicable indexation relief and the incidental costs of acquisition and disposal. This loss, however, was a loss on a disposal to a connected person and therefore, by virtue of the Taxation of Chargeable Gains Act 1992 s.18, was only off-settable against other disposals to Brickfields.